Privatization Projects – Managing the Interest Rate Risk

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Not even ten years have passed since the first-ever full public-private partnership (PPP) project took place in Saudi Arabia. Since then, we have seen an accelerating push by the government to embrace privatization in its few forms, including PPPs and full/partial asset sales. Focusing on the core objectives of enhancing private sector participation in the economy and reducing the public sector's spending burden, the government established the National Center for Privatization (NCP) in 2017 as an enabler of privatization in the Kingdom. Besides fostering environmental and social sustainability, the private sector could possibly bring innovation, expertise, and efficiency. Hence, the government is moving toward facilitating and regulating the services rather than being its sole provider.

The growth of privatization initiatives and projects, namely PPPs, creates a need for more information and guidance around managing financial risks from the private sector perspective. This article focuses primarily on interest rate risk related to privatization and project finance transactions.

For such projects, the debt element typically constitutes most of the investment value with duration spanning more than fifteen years. At the outset of every project, the private party, which is usually a consortium, should consider the nature and implication of assuming the interest rate risk. What areas, within interest rate risk spectrum, deserve the most attention, and how can we implement the best industry practices?

CONSIDERATIONS BEFORE THE BID STAGE

Regardless of the privatized sector under consideration (water, education, health, transport, renewables, etc.), interest rate exposure has a common set of risks that ought to be delicately considered. Given the complexity and nature of such projects, it is in the best interest of the project company to have a clearly demonstrated plan around the management of interest rate risk (referred to as hedge strategy). The process would intuitively start from the tendering stage, where the procuring authority specifies its requirements in terms of the bidder's interest rate assumption model, hedging strategy, and rationale for the selected strategy.

The challenges we observe locally (at the bidding stage) include the need to construct a robust methodology for interest rate assumptions beyond the SAR liquid curve. The problem becomes more apparent when the project spans over two decades (or even longer) with the underlying exposure in SAR. The assumptions should include the different applicable swap spreads, such as market and credit. In addition, the pre-bid hedge strategy should consider the appropriate hedge execution process that is signed off on by the lenders/hedge counterparties, as well as the alternative hedge instruments that

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are best suited for the debt plan. More importantly, what is the minimum reasonable hedge ratio (hedge quantum), and what is the optimal hedge duration? To answer these questions and more, the project company should think about its risk management objectives along with its financial covenants.

In part, the decision around such an important aspect is a function of the flexibility to withstand interest rate fluctuations and its impact on the related financial covenants. Nonetheless, the lenders would always want to see the debt exposure hedged as much as possible, but is that still advisable? How would the bidder propose a different rationalized hedge quantum? Hedging excessively could lead to less flexibility for the bidder in managing its utilization sculpted interest-bearing debt. Yet the less the hedge quantum is, the more vulnerable the financial covenants are. Therefore, it is advisable to identify the optimal hedge strategy and understand the trade-offs rather than falsely pursuing an aggressive or conservative hedge strategy.

Once the bid is submitted, the procuring authority or off-taker faces the challenge of forming a fair and comparable approach when looking at many distinct hedge interest rate assumptions and hedge structures from multiple bidders. It is important to verify that all bidders base their hedging structures and strategies on a like-for-like and transparent basis (identifying any irregularities in their pricing model) in order to establish uniformity of the final aspects across all bidders. A deep understanding and expertise are needed to establish and validate the financial models in this regard. Given the relatively young PPP/project finance market locally, this particular area is often overlooked or not properly covered as per the best industry practices, which can lead to inconsistencies when attempting to identify the best bidder.

POST WINNING THE BID

The hedge strategy implementation process kicks off the minute the project company wins the bid. Proper coordination must occur between the project company, its lawyer, hedge providers, and lenders to address all aspects of hedge documentation. One critical agreement that is often negotiated, although not as often locally, is the International Swaps and Derivatives Association (ISDA) agreement. This governs the hedging transactions and relationship between the project company and the hedge providers. Careful consideration should be placed to negotiate the commercial terms and provisions within the agreement (the legal issues are handled by the lawyer). It is essential to ensure that such documentation does not include any clause(s) that may disadvantage the project company in the future concerning the potential treatment of the hedging in circumstances such as refinancing or debt restructuring.

The negotiation with the hedge providers would also start during this stage to establish a transparent hedge execution process, accompanied by an efficient execution script for the required hedging. Once this is agreed, and the project moves closer to the Financial Close stage, the project company's hedge advisor begins a critical step called the benchmarking process. This takes place with each lender/hedge bank to confirm a clear and accurate understanding of hedge implementation. At this step, potential pricing discrepancies with the hedge provider(s) are identified via the several pricing dry runs (testing process),

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which are intended to demonstrate a smooth and transparent execution protocol. The objective is to maintain the agreed-upon hedge structure throughout the benchmarking process to ensure its accuracy at the Financial Close.

The final step here is to conduct live execution of the hedge during the Financial Close stage. It is imperative to identify any undisclosed margins that may be included in the live pricing and negotiates the removal of these margins. In some circumstances that we have observed, the project company could look to introduce a third-party market maker into the transaction and run a competitive process to reflect the prevailing market levels. How significant is this exercise? Each one basis point (0.01%) extra spread in a typical project finance transaction hedge represents a considerable dollar value that would otherwise benefit the project company and potentially improve its Internal Rate of Return (IRR). Some other PPP transactions are set up so there could be a risk- or profit-sharing plan (up until the Financial Close) with the procuring authority/off-taker when it comes to interest rate risk. However, regardless of the setup in place, an efficient execution is necessary to maximize the project's overall commercial value. Following these steps would make any further hedges to come undoubtedly more efficient and economically sound.

CONCLUSION

By its nature, PPPs are complex structures that require higher scrutiny and careful consideration. Other market risk exposures, such as foreign exchange risk, should also be thoroughly covered. Catching up with the global best practices and standards in that regard is not easy. However, considering how the learning curve is being shaped now and with more projects to come, we will be able to get there earlier than anticipated. When it comes to interest rate risk management and hedge implementation plans, obtaining independent, expert advice is of the utmost importance. We believe utilizing deep expertise means the project company acts in the best interest of its shareholders, on a micro-level, and of its stakeholders, including the procuring authority, on a macro-level.

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